Chapter 1: Executive Summary

Mortgage Origination and Securitization in the Financial Crisis

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Background

One of major catalysts for the current financial crisis was the spate of defaults and foreclosures in 2007 and 2008, which also generated considerable dead weight costs in their own right. Two big reasons for all the defaults and foreclosures were the downturn in house prices, coupled with a dramatic decline in the quality of mortgage loans. Several factors in the mortgage market contributed to this latter reason:

- Loan quality declined in large part because of one particular unintended consequence of securitization, namely, that mortgage lenders did not bear the costs of these declines in loan quality, and so did not care about them.
- Another likely reason for the decline in loan quality was the failure of lenders to understand exactly the terms of the loans they were being offered, which rendered them unable to internalize the costs of default and foreclosure fully.
- The majority of the loans in the subprime sector were hybrid adjustable rate mortgages (ARMs) with fixed rates for 2 to 3 years and adjustable rates thereafter. Because these adjustable rates were offered at very high spreads, the mortgages were, for all intended purposes, meant to be refinanced or to default at the end of the 2 to 3 year period. The 2/28 and 3/27 ARMs were being offered around the same time thus creating the potential for an unexpected systemic wave of refinancings or defaults.

The main reason for the financial crisis, however, was not these factors. We argue that the primary culprit was that financial institutions did not follow the business model of securitization by transferring the credit risk from their balance sheets to capital market investors. That is, by holding large amounts of mortgage-backed securities (MBSs) tied to nonprime mortgages at the time of their defaults, a number of financial institutions (like Citigroup, UBS and Merrill Lynch) suffered huge losses as the values of these securities tumbled.

The Issues

How should mortgage loan origination and securitization be regulated in the aftermath of the crisis? Some of the major regulatory questions are:

1. Can "predatory lending" be identified and, if so, how can it be regulated? Will this regulation get rid of the systemic nature of some of the mortgage products?
2. How much standardization of mortgage loans is needed? How should conforming limits be set?
3. What regulatory limits (if any) should be placed on securitization?

A set of principles can help frame the answers to these questions.

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Choice and innovation is good and non-standard contracts can add value, because different households, by virtue of where they are in the life-cycle and the properties of their labor income risk, prefer different contracts. At the same time, standardization is good because it promotes liquidity in the mortgage backed securities (MBS) market because standardization makes the securities easier to value. Standardization also limits predatory lending. There is clearly a tension between providing mortgage customers with choice and innovation while at the same time protecting them from predatory lending practices

Loan originators and mortgage brokers need to be incentivized to internalize the externalities created by the dead-weight costs associated with defaults and foreclosures. Making sure mortgage customers fully understand the terms of all loan products offered to them helps them to internalize the costs that they bear in the event of default or foreclosure. Including provisions for efficient renegotiation and reorganization of a loan in event of default can not only reduce the deadweight costs of foreclosure but can also make it more difficult to securitize the loan. There is therefore a trade-off and the exact nature of any included provisions is likely to be important.

Policy Recommendations

1. The recent amendments to Regulation Z (Truth in Lending) by the Federal Reserve Board are a big step towards protecting consumers from predatory practices among mortgage originators in the subprime space. The new protections need to be construed literally so that they do not restrict the income and asset combinations that creditors are allowed to find acceptable. It is highly likely that this will remove the systemic nature of the mortgage products.

2. Conforming loans should continue to be standardized and efforts should be made towards standardization for non-conforming loans. Households should also have access to non-standardized products which should be subject to additional regulatory vetting to ensure that no predatory lending is involved. Under the Housing and Economic Recovery Act of 2008 (HERA), the conforming national loan limit is set each year based on changes in average home prices over the previous year, but cannot decline from year to year. We support this calculation of the limit. We call for the GSEs' current mandate under the government's economic stimulus package to purchase loans beyond the conforming national loan limit in "high-cost" areas to become permanent. We also support tying the conforming "high-cost" area limits to regional house price indices. Since 125% of the median house price seems quite conservative, we favor that number over the more stringent 115% that has been adopted for next year. Finally, we support the abolition of the maximum dollar cap on the loan.

3. As before, loan originators should be able to securitize any standardized conforming mortgage products in the form of mortgage-backed securities. Loan originators of nonconforming loans should have "skin-in-the-game." While the private market should be able to solve this problem without regulation, one of the impediments is that these solutions will fail if anywhere in the securitization chain a government guaranteed financial institution (e.g., GSE, deposit institution, "too-big-to-fail" firm) is involved. For these cases, the guaranteed institutions may need to require that the originators (i) hold a fraction of the loans; (ii) amortize the origination fee over some period of the loan; or (iii) not be able to "sell" the mortgage servicing rights.

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